Economics and Sociology

Ocassional Paper No.1308

AGRICULTURAL CREDIT SYSTEMS AND SAVINGS MOBILIZATION: ISSUES AND PROBLEMS

by

Richard L. Meyer

Paper presented at the

Seminar on Agricultural Credit

Ilorin, Kwara, Nigeria

October 26-31, 1986

Agricultural Finance Program

Department of Agricultural Economics

and Rural Sociology

The Ohio State University

Columbus, Ohio, 43210

Introduction[1]

In spite of billions of dollars of foreign assistance, thousands of man-hours of technical consultants, and hundreds of studies, most agricultural credit systems in developing countries fail to meet their objectives. Part of the problem in recent years can be traced to low farm commodity prices prompted by world recession and restrictive trade policies, to high and variable rates of inflation, and to poor growing conditions in some countries. More frequently, however, these problems simply expose and exacerbate more fundamental weaknesses within the credit systems themselves. These weaknesses can often be traced to the supply-leading concepts used to develop financial institutions and policies.

Supply-Leading Finance

A supply-leading financial development strategy is one designed to increase the supply and reduce the cost of loan funds to priority sectors, and provide to technical and investment services to entrepreneurs through the financial sector. A supply-leading strategy frequently includes:

1. creation of specialized financial institutions (especially development banks),

2. ready supply of cheap funds through rediscount operations of central banks, lending quotas, and portfolio regulations,

3. targeting of loans to borrowers for specific purposes, and

4. low nominal interest rates on loans often resulting in negative real rates.

Some positive results have been obtained in some countries that have followed this strategy. Agricultural production has increased, new technolgy has been adopted, investment has increased, and institutions have improved their capacity to make farm loans. The negative effects, however, outway the positive effects in most cases, and these include:

1. little sustained increase in the real supply of credit for agriculture,

2. concentration of loans among richer farmers and regions that worsens income and wealth distribution,

3. little increase in the term structure of farm loans,

4. high transaction costs for formal loans,

5. high delinquency and default rates,

6. poor quality accounting systems that inflate income estimates of institutions and mask loan recovery problems, and

7. unviable financial institutions that survive only because of subsidies.

Although there are exceptions, these problems are found in many different institutional forms in countries at different stages of the development process. In many cases, the degree of severity of these problems is inversely related to the degree to which the financial institutions mobilize deposits used for their agricultural loans.

Saver-Dominated Institutions and Deposit Mobilization

Institutions in a supply-leading system are often borrower-dominated, that is, their operations, policies, procedures, and incentives are oriented towards borrowers, making loans, and rewarding performance on the criterion of loans made. Saver-dominated institutions, on the other hand, are oriented towards mobilizing funds, lending them carefully, and recovering the loans made so the funds are available when savers demand them.

Recent analyses have shown that increased deposit mobilization through rural financial institutions can yield several benefits for rural households, financial institutions, and the economy:

1. Savers receive benefits when provided with a safe place to save that also pays them an attractive return. Usually the number of depositors exceeds the number of borrowers in an institution so more people are benefitted by a strong savings program than by a lending program, and many savers in financial institutions are low income so income distribution is improved.

2. The viability of financial institutions can improve because a) deposits can be a more dependable source of funds than governments or donors, b) deposits may actually be less costly to the institution once complete accounting is made for all costs associated with "cheap" rediscount or other funds, c) combining deposit mobilization and lending may lead to economies of scope, d) the information gained by providing

deposit services to a household may be useful when screening applicants for loans, e) institutions may take more care in lending when using deposit funds, and f) loan recovery may improve when borrowers recognize that their delinquent loans represent their neighbors' deposits.

3. Greater deposit mobilization strengthens domestic resource mobilization and reduces the need for external funds.

Issues and Problems in Deposit Mobilization

Converting a borrower-dominated institution into a saver-dominated one and creating a system of financial intermediation in order to achieve the benefits outlined above represents a significant challenge. The policies that created and support the supply-leading system must be changed, but the interests that benefit from that system may have become strong and entrenched. The view that rural people cannot save may also be difficult to change in spite of the considerable evidence to the countrary that now exists.

The first set of issues to be addressed in developing a deposit mobilization strategy concerns the factors that influence the ability, willingness and opportunity of rural households to save. These factors are now fairly well understood in general terms, although the importance of each varies among countries:

1. Political, social and legal environment. A depositor must be confident in the future value of his/her deposit. Civil disturbances, political upheaval, rampant thievery in

public and private institutions, little legal recourse for those suffering losses, represent impediments to deposit mobilization because they destroy confidence in financial instruments and institutions.

2. Per capita income. Income is an important factor that influences savings because the higher the income level of a household the higher should be the average savings rate (but not necessarily the marginal savings rate). Unfortunately, there is little that can be done in the short term to rapidly increase rural income.

3. Interest rate. Financial savings are expected to be positively related to the interest rate paid on deposits even though aggregate savings may be only marginally influenced by interest rates. Interest rates may need to be high enough to assure sustained positive real rates in order for households to perceive the value of financial savings. Rates also need to be high enough to compete with the rate of return that can be earned on nonfinancial investments.

4. Transaction costs. Some of the same factors that determine the transaction costs for borrowing can be expected to determine the cost of making and withdrawing deposits in a financial institution. The greater the transaction costs, the lower will be the net return earned by the depositor for any given interest rate. Access to financial services is affected by the geographic spread of financial institutions in rural areas, and the availability of roads and vehicles to reduce travel time. Infrastructure investments and regulations

concerning bank branching can influence transaction costs. Transportation and communication infrastructure also influences the cost of operating a financial institution.

5. Service. Many borrower-dominated institutions ignore quality of service because, with low interest rates and the resulting excess demand for funds, they need to discourage customers rather than attract them. For deposit mobilization to succeed, however, customers must perceive that service is good so institutions must develop a service-oriented approach that attracts rather than discourages customers.

6. Appropriate instruments and incentives. Financial instruments must fit the needs of rural households. Restrictions on size of deposit, maturity period, notification necessary for withdrawals and other conditions useful for funds management for the institution must be conditioned by concerns for the liquidity needs of the household. The possibility of getting a future loan is often a powerful motivation for saving. Deposit instruments that offer loans for livestock, machinery and rural housing after a minimum amount of savings have been accumulated may provide special incentives for some households. Other households may be attracted by programs that offer prizes for opening an account or the chance of winning a large sum in a lottery.

The second set of issues in developing a deposit mobilization strategy concerns the technical, administrative and organizational requirements of saver-dominated institutions operating in rural areas of developing countries. Some examples of these issues include:

1. Asset and liability management. Rural institutions that mobilize deposits for lending must deal with seasonality in supply of and demand for funds, matching of the term structure of deposits and loans, and ready access to funds to meet withdrawals. Asset portfolios must be adequately diversified to reduce risks. These issues are more demanding for institutions that mobilize deposits than for those that rely on central banks or governments for their funds.

2. Operational efficiency. It is a major challenge for institutions to develop cost-effective ways of managing large numbers of small farm loans. Rural deposit mobilization imposes the additional challenge of efficiently and accurately handling an even larger number of deposit accounts.

3. Personnel and procedures. By developing their own localized programs, local institutions have a better opportunity than distant government agencies to identify and provide those financial services that are really useful in rural areas. They may also be in a better position to decide what to lend for and to whom. These decisions, however, may require better talent and more sophisticated manpower than is necessary in the typical borrower-dominated institution. They also may require more knowledge of the local environment than is possible to obtain in the frequent rotation of personnel common in many institutions. They will normally require more decentralization of authority and decision-making than is currently practiced.

4. Regulation and inspection. Whereas the myriad rules and regulations currently used to target loans are counterproductive, some regulation of financial institutions is clearly needed to ensure safety of deposits and adherance to sound lending practices. A program of frequent and careful inspection is required with certain and speedy punishment of those who break the rules.

Conclusion

There is not likely to be a single unique form of financial institution that will best serve a rural area. Furthermore, the choice of institution may be less important than creating the correct environment in which institutions must operate. Some key financial principles need to be observed regardless of institutional form. These include providing an adequate spread to cover costs, diversifying loan portfolios, making loans only to creditworthy borrowers, developing a good political and legal environment for loan recovery, and stimulating institutions to mobilize funds and create innovations for rural financial intermediation. When borrower-dominated institutions are converted into saver-dominated ones, a set of forces are set into motion that can improve the delivery of credit to rural areas. More importantly, however, this change along with an improvement in the productive capacity of agriculture can improve the conditions for rural financial intermeditaion and the prospects for sustained financial and agricultural development.

Footnotes

1. This paper relies heavily on the work of several people, especially my colleagues at OSU: Dale W Adams, Carlos E. Cuevas, Claudio Gonzalez-Vega, Douglas H. Graham and Donald W. Larson. Several publications are cited in the bibliography that discuss more fully the ideas summarized in this short paper. Much of the work done at OSU in recent years has been financied by AID. However, the views in this paper are not necessarily those of my colleagues or AID.

Bibliography

Adams, Dale W, 1981, A Critique of Traditional Agricultural Credit Projects and Policies. Journal of Development Economics, 8, 347-366

Adams, Dale W, Douglas H, Graham and J. D. Von Pischke, 1984, Undermining Rural Development with Cheap Credit. Westview Press, Boulder.

Cuevas, Carlos and Douglas H. Graham, 1984, Rationing Agricultural Credit in LDC's: The Role and Determinants of Transactions Costs for Borrowers. Paper presented at the 1985 International Conference of Agricultural Economists, Malaga, Spain.

Gonzalez-Vega, Claudio, 1984, Credit-Rationing Behavior of Agricultural Lenders: The Iron Law of Interest Rate Restrictions in Undermining Rural Development with Cheap Credit.

Kessler, Denis and Pierre-Antoine Ullmo (eds.), 1984, Savings and Development. Ed. Economica, Paris.

Meyer, Richard L., 1985, Deposit Mobilization for Rural Lending. Third Technical Consultation on the Scheme for Agricultural Credit Development, FAO, Rome.

Mittendorf, H. J., 1984, Savings Mobilization for Agricultural and Rural Development in Africa in Savings and Development.

Von Pischke, J. D., 1983, Toward an Operational Approach to Savings for Rural Developers in Rural Financial Markets in Developing Countries, J. D. Von Pischke, Dale W Adams, and Gordon Donald (eds.), John Hopkins University Press, Baltimore.